Gitanjali Gems

A popular choice in diamonds

Initiation
Overweight

Rs226.80

10 April 2008
Price Target: Rs400.00

India
Specialty Retailing

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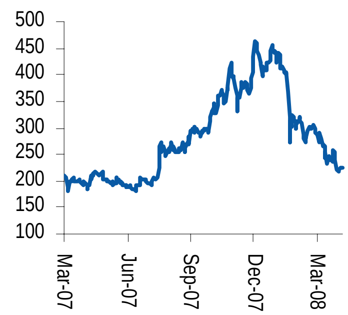
- **Initiate with Overweight:** Gitanjali Gems is India's leading gem and jewelry company, and we initiate coverage on the stock with a March-2009 price target of Rs400, implying a potential upside of 78% from the current share price.
- **Integrated player with a popular brand portfolio:** Gitanjali Gems is among the few gem and jewelry companies in India that have fully integrated operations. Its supply chain infrastructure, diversified and popular brand portfolio, and retail penetration are matched by very few companies in the industry.
- **Catalysts, share price drivers:** (1) Higher resilience to slowdown expected in the US and India markets as the share of jewelry sales to overall market is very small; (2) Significantly improved balance sheet profile post GDR offering, which can support growth rates of up to 50% in the medium term without any risk of dilution; and (3) Hyderabad SEZ moving into a fully operational phase over next 3 months, and a possible tie-up with co-developer for Hyderabad and other SEZs to unlock value and improve pace of execution.
- **Price target, valuation, key risks:** Considering that risk and return profile of various growth drivers are different, we adopt a sum-of-the-parts approach. Our price target for the company implies an EV/EBIDTA multiple of 9x and P/E multiple of 12.5x for the core business based on FY10 estimates. Key risks are: (1) any significant decline in consumer spending, and (2) any policy / taxation / legislation changes that impact spends on luxury goods.

One-year share price performance

Rs



Source: Datastream.

Reuters: GTGM.BO, Bloomberg: GITG IN

Rs in millions, year-end March

	FY07	FY08E	FY09E	FY10E
Net sales	34,674	48,232	58,583	71,382
Net profit	978	1,565	2,048	2,774
EPS (Rs)	16.6	16.0	19.1	25.8
DPS (Rs)	1.6	2.4	2.9	5.2
Net sales growth	40%	39%	21%	22%
Net profit growth	82%	60%	31%	35%
EPS growth	30%	-3%	19%	35%
ROE	12%	10%	8%	10%
ROCE	9%	9%	10%	12%
BVPS (Rs)	148	232	255	275
P/E (x)	13.7	14.1	11.9	8.8
P/BV (x)	1.5	1.0	0.9	0.8
EV/EBITDA (x)	18.4	10.8	8.6	7.1
Dividend yield	1%	1%	1%	2%

52-week range (Rs)	177-480
Market cap (Rs MM)	24,381
Market cap (US$ MM)	610
Shares O/S (MM)	108
Avg daily value (Rs MM)	199
Avg daily value (US$ MM)	5.0
Avg daily volume (MM)	0.7
Index: BSE Sensex	15695
Exchange rate (Rs/US$)	40.0

ADR/GDR	$6.00
Reuters	GITGq.L
Bloomberg	GITG LI
52-wk range	6-11
Ratio	1
Avg daily volume	2315
Current prem (%)	5%
13-wk avg disc (%)	-7%
52-wk avg prem (%)	NA

Performance	1M	6M	12M
Absolute (%)	-15%	-37%	11%
Relative (%)	-14%	-25%	-7%

Source: Company reports and JPMorgan estimates. Note: Share price as of April 10, 2008; EPS is calculated on fully diluted shares.

See page 38 for analyst certification and important disclosures, including investment banking relationships.

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Company description

Established in 1986, Gitanjali Gems is one of the largest integrated diamond and jewelry manufacturing companies in India. Its operations include cutting and polishing rough diamonds sourced from suppliers in international markets, mainly for exports and the manufacture and sale of diamond jewelry in India and international markets. Its retail sales and distribution network consists of 112 distributors and 1,250 outlets in India and 143 retail outlets in the US. The company has also forayed into SEZ operations and is in the process of establishing its first gems & jewelry SEZ at Hyderabad. It intends to develop and lease over 25MM sq ft of space at this SEZ.

Investment summary

Gitanjali Gems significantly outperformed the Sensex in 2007. Since then, economic developments in the US and India have raised concerns about its near-term growth prospects and the stock has been an underperformer YTD—a trend also witnessed in other retail names. We believe the stock price performance has completely overlooked the recent moves by the company in consolidating its brand ownership (increased stake in Gili from 65% to 100% and Nakshatra from 33% to 100%) and significantly improved balance sheet profile post its GDR offering. Looking beyond recession and slowdown concerns, we remain positive about the long-term growth opportunities in India and overseas markets such as the US and China. We believe the company is well positioned to deliver earnings CAGR of 33% for FY08-10. We initiate coverage on the stock with an Overweight rating and a March-2009 price target of Rs400, implying a potential upside of 78% from the current price.

We believe branded jewelry contributes less than 10% of the gems and jewelry sales in India, and, therefore, there is significant scope for the company to expand its market share and maintain growth rates significantly above the industry. Our confidence in growth rate is also supported by the company's excellent supply chain infrastructure (manufacturing operations in Surat, Mumbai, and Hyderabad), wide brand portfolio (eight jewelry brands with good recall), and retail penetration (sold through nearly 1,400 outlets).

Gitanjali's expansion into US retail has been viewed with concern. However, we believe that these acquisitions are small and help the company to build domain expertise and improve its overall margins owing to scale that it provides in diamond purchases. The company would back these operations by an excellent supply chain infrastructure in India, and we expect a payback period of less than three years on these investments under constant sales assumption.

Since the recent GDR offering, the balance sheet profile of the company is much improved, with a net worth of US$500 million (equivalent to its current market cap) and a net debt/equity ratio of 0.4 / 1.0. We expect this profile can support a growth rate of nearly 50% without risk of any further dilution.

Gitanjali is also engaged in de-risking its long-term earnings dependence by exploiting selective opportunities in lifestyle/luxury goods and special economic zones (annual rental incomes from Hyderabad SEZ on completion of about 10 million sq ft after 6 years could be as much as US$100 million). Considering a similar clientele base, the company's recent foray into luxury goods should add to long-term growth rates. The SEZ initiatives should also add value to its long-term earnings growth, and we expect a total investment outlay for this foray not exceeding US$100 million.

We expect the Hyderabad SEZ itself to deliver value that is twice the expected total outlay for all the six SEZs. The Hyderabad SEZ should move into an operational phase over the next three months, and we believe this will be an important catalyst for the stock. The company is also engaged in scouting for a co-developer for this SEZ to unlock value and assist in speedy implementation of the entire project. We derive value of US$200 million for this SEZ based on some conservative development plan (25 million sq ft as against a permissible development plan of 40 million sq ft) and rental assumptions. Our valuation implies a value of US$1 million per acre of land—this appears conservative as compared to the recent land transactions around the city which have been in the region of US$3-4 million per acre.

Our price target for the stock is based on sum-of-the-parts approach. We value the jewelry business for the company in line with its peers, and believe there is room for upside if it maintains the current pace of execution.

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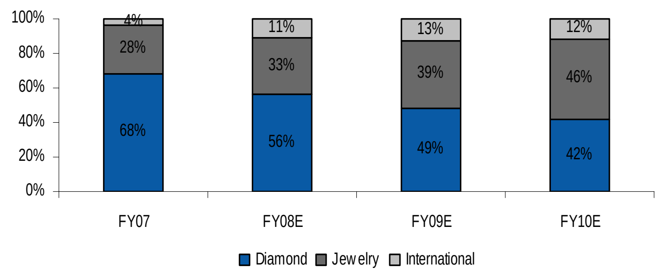
Investment positives

Scaling up branded jewelry business in India

From just being a diamond processing company in 2005, Gitanjali Gems has come a long way in steadily shifting its business profile to jewelry manufacturing and retail. In 9M FY08, jewelry accounted for 43% of the company's revenues compared to 15% in FY06. Its core strategy focuses on capturing a larger share of jewelry manufacturing and retailing, which accounts for 60% of the value chain. In 9M FY08 jewelry also contributed to 63% of the operating profit as compared to the 38% in FY06. These trends clearly demonstrate the changing business dynamics. There are four key drivers to grow the jewelry business for which the company has charted out specific growth plans: (1) exports, (2) domestic retail, (3) international retail, and (4) wholesale. Jewelry retail is the key thrust area for Gitanjali for which it has committed huge investments to scale up its retail operations both in the domestic and overseas markets.

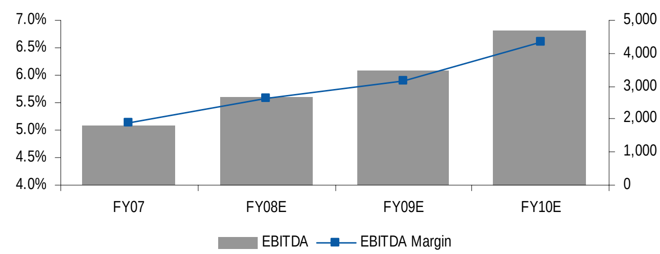
We estimate the share of jewelry to rise from 43% currently to nearly 60% in overall sales by FY10. We estimate that this would in turn help to improve the overall operating margins from 5% in FY07 to 6.6% by FY10.

Figure 1: Gitanjali Gems—Consolidated revenue mix
%



Source: Company reports and JPMorgan estimates.

Figure 2: Gitanjali Gems—Consolidated EBITDA and EBITDA margin trends
Rs in millions, %



Source: Company reports and JPMorgan estimates.

Gitanjali's core diamond processing business is likely to grow at 4-5%, driven largely by price hikes for polished diamonds in response to the rise in prices of rough diamonds. However, going forward, the company would increasingly process diamonds for its own captive consumption in the retail operations, and, therefore, the share of exports will likely come down. The sightholder status with DTC and access to other primary diamond suppliers ensures a steady supply of rough diamonds at competitive prices.

We are witnessing healthy demand trends for jewelry exports from India, with Gitanjali's exports growing at a healthy pace of 25% during FY02-07 and the company continuing to focus on capturing a higher share of export growth. With a wide design database, strong marketing teams in key markets like the US, Europe and Southeast Asia, and a rising client base, we expect this growth momentum to continue going forward. Accordingly, we expect this division to register a 20% growth over FY08-10E.

The company plans to achieve over 50% top-line growth for its domestic jewelry retail business; it targets to capture the branded jewelry segment in India which is growing at 20-25% p.a. Gitanjali retails its products under brands like *Asmi*, *Sangini*, *Nakshatra*, *D'Damas*, and *Gili*, which enjoy strong brand equity across the nation. The company has rapidly increased its retail presence from 650 outlets in March 2006 to 1,246 currently. So far, exclusive distributors and shop-in-shops in various department stores have been the key contributor to retail sales, accounting for nearly 70% share of the retail sales. However, Gitanjali now intends to increase the share of its own stores to 90 over the next two years in addition to the 10 currently. We estimate retail sales to increase at a CAGR of 53% over FY08-10E.

Table 1: Key jewelry brands of Gitanjali

Brand	% ownership	Description
Asmi	100%	Premium work wear collection
Sangini	50%	Entire product range including bridal jewelry
Nakshatra	100%	Entire product range including bridal jewelry
Gili	100%	Diamond jewelry at reasonable prices
Vivaaha	100%	Wedding jewelry
Maya	100%	Gold jewelry for wedding and other similar events
D'damas	51%	International quality designs combined with Indian values

Source: Company, JPMorgan.

International retail is a key part of growth strategy

Expansion into retail markets overseas, in our view, would provide the next leg of growth for Gitanjali. The company plans to leverage its manufacturing capabilities to capture a higher share of jewelry retailing in overseas markets through the inorganic growth route, and has identified the US as a key target market as it accounts for 50% of the global diamond jewelry consumption. Currently, the jewelry market in the US is highly fragmented and growing at a comparatively slower pace of 5-6% p.a. We are witnessing a consolidation in this market, and believe that Gitanjali could be a key beneficiary of this process. Also, it would be able to improve the margins of its acquisitions substantially via its integrated operations.

Gitanjali has so far acquired an 84% equity stake and intends to acquire up to an additional 13% equity stake by December 19, 2008, in Samuels (a large jewelry chain in the US with revenues close to US$100 million). It currently manages 97 stores in and around Texas. Management targets to produce a majority of the jewelry for this chain in India, thereby reducing costs and improving profitability. It targets to open 5-10 stores per annum under Samuels and double the operating margins for this retail chain in the coming 2-3 years. We expect revenues for Samuels to grow at 5-7% over the next three years and operating profitability to improve from under 1% currently to 7% over the same period.

Rogers is another acquisition that Gitanjali announced recently in November 2007. The acquisition multiple was similar to that paid for Samuels, and it should contribute US$80 million to the company's overall sales in FY2009.

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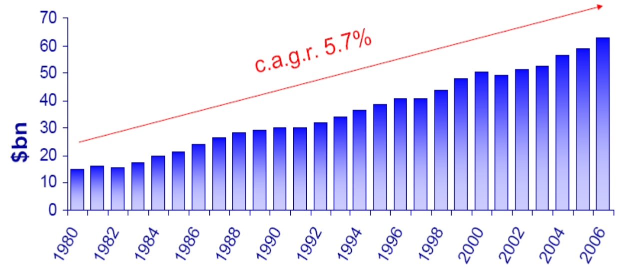
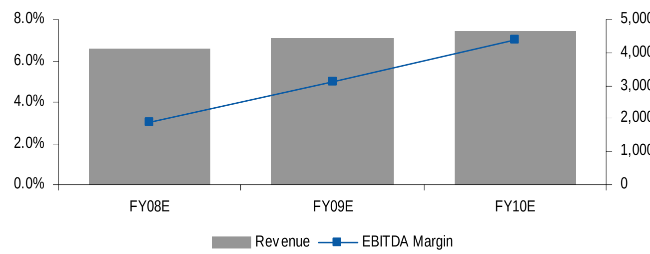
Figure 3: US jewelry and watch market
US$ in billions



Source: US Department of Commerce, Signet.

Figure 4: Revenue and margin growth for Samuels
Rs in millions, %



Source: Company reports and JPMorgan estimates.

We believe Gitanjali will continue to scout for opportunities and alliances to gain a bigger share of the US market and utilize its manufacturing capabilities to capture a larger share of the value chain. China also remains a focus market for the company, and it is currently looking for alliances there. A recent survey conducted by DTC in China indicated that the overall ownership of diamonds in China remains low at 11%, highlighting the vast opportunity available for diamond jewelry retailing in the country.

New growth avenues: Lifestyle retailing and SEZ

The potential for lifestyle retailing in India is huge considering that Indians attach significant importance to brands. Lifestyle and attitudinal changes, consumerism, and rising income levels will continue to provide growth momentum to high-end brand retailing in the country. In order to leverage on these high-growth opportunities, Gitanjali Gems is making a foray into the retailing of additional lifestyle products like watches, leather products, health and beauty products, and fashion accessories.

Although jewelry would still remain an important contributor of revenues, we believe this foray would help in maximizing store throughput and attract larger footfalls.

Table 2: Recent acquisitions and alliances done by Gitanjali for its lifestyle retail operations

Company	Joint Ventures/Acquisitions	Products	Key brands
Trinity Watch Company	Acquired	Watches	Iris, Saint Hanore, Umbro , Everest
Hoop Silver Jewellery	Acquired	Fashion jewelry	Hoop
MoU with Mariella Bitrani Fashion Group, Italy	Joint Venture	Luxury goods	Mariella Burani, Baldinini, Rosato, Calgaro and Facco
Morellato India Pvt Ltd	Joint Venture	Watches, leather goods, writing instruments, jewelry	Morellato, Miss Sixty, Just Cavalli, Molecole, John Galliano, Roberto Cavalli, Philip Watch, Pirelli, Pirelli Pzero, Sector, Moschino

Source: Company reports.

Besides luxury retailing, Gitanjali Gems is also keen on participating in the SEZ opportunity, which would add to its long-term growth rates. SEZs offer substantial tax benefits to both occupants and developers. Space remains a large constraint at all existing SEZs in the country, and, therefore, we believe the new SEZ will not find it extremely difficult to attract occupants. The Hyderabad SEZ enjoys significant locational advantages and we expect a total development of 25 million sq ft (according to management, current FSI rules permit them to go up to 40 million sq ft). It is currently working on six SEZs (Table 4). However, it has acquired land only for the Hyderabad SEZ so far, and is in the process of acquiring land for the other six

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SEZs. Skilled labor is another key requirement for a diamond and jewelry manufacturing hub, and a dedicated training centre with a capacity to train up to 1,200 workers has been set up. We expect the Hyderabad SEZ operations to move into a fully operational phase over the next three months, and, therefore, we ascribe value to this initiative. The Government of India, in its annual economic update, has cited the Hyderabad Gems SEZ as one of the model SEZs under development in the country.

Table 3: Tax benefits for SEZs

	Unit/Occupant	Developer/Co-developer
Development stage (Capital goods, consumables, components & spares)	No custom duty No excise duty No sales tax No service tax No purchase tax No stamp duty & registration fees No stamp duty on mortgages No electricity duty	No custom duty No excise duty No sales tax No service tax No purchase tax No stamp duty & registration fees No stamp duty on mortgages No electricity duty
Operation stage (Raw materials, Consumables, Components & Spares)	As above	As above
Profit stage	Exemption from income tax - 100% for the first 5 years - 50% for the next 5 years - 50% of profits ploughed back for the next 5 years No MAT	No income tax for 10 years (80 IAB) No MAT No dividend distribution tax (115 O)

Source: IL&FS.

Table 4: Gitanjali Gems—SEZ operations

Location	Sector	Area (hectares)	Approval status
Hyderabad	Gems & jewelry	80.93	Acquired land and notified by central government.
Raigad	Gems & jewelry	10.2	Formal approval received from central government
Aurangabad	Gems & jewelry	50	In-principle approval received from state government
Nanded	Gems & jewelry	50	In-principle approval received from state and central government
Nashik	Multi services	100	In-principle approval received from state and central government
Nagpur	Multi product	1000	In-principle approval received from state government

Source: Company reports.

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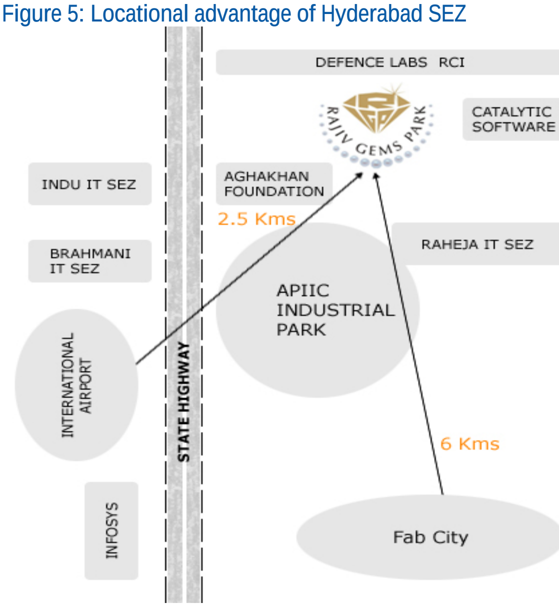
Figure 5: Locational advantage of Hyderabad SEZ



Source: Company data.

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Investment negatives

Rising competition in the branded retail market

The Indian branded jewelry market is witnessing increasing competition, given the high-growth potential being offered by this highly under-penetrated category. *Tanishq* (a leading jewelry brand from Titan) has expanded its operations significantly in the last few years, and has gained considerable market share in the overall market which largely remains unorganized. Titan is now implementing a two-pronged strategy of maintaining its share in the branded jewelry market. It targets to increase the sales of diamond jewelry in its overall sales, and is also simultaneously foraying into the mass segment through the launch of Goldplus stores.

Besides *Tanishq*, the leading national jewelry brand, many companies like Rajesh Exports and Rosy Blue, which so far have largely been exporters of gold and diamond jewelry, are now turning their attention towards retailing their products which offers higher margins. Reliance Retail, too, is likely to expand its presence in the jewelry retail space in a big way which would further intensify competition.

High bargaining power of suppliers

The procurement of rough diamonds is from fairly concentrated sources, such as Diamond Trading Corporation (DTC), and downstream companies such as Gitanjali Gems have very low bargaining power. Mining companies, through their marketing arms such as DTC, can exercise significant control over the pricing of polished diamonds by adjusting the quantity and pricing of rough diamonds. Historically, an increase in rough diamond prices has been passed onto customers; however, in the face of rising competition, there could be periods when margins could get impacted. The company, through its promoter group companies, enjoys sightholder status with DTC and is better placed compared to its peers in the procurement of diamonds.

Low FCF and high working capital requirements

The nature of industry is such that working capital requirements are significantly high and impact free flow cash generation. Average outstanding inventory and debtor days are in the region of 180 days, and nearly 90% of total capital is employed in these areas. We estimate incremental working capital requirements would be in the region of Rs7-8 billion to support incremental sales of Rs24 billion over the next three years. We believe the recent GDR offering, to a large extent, will help in meeting this requirement, and we do not envisage any further dilution in capital.

SEZ is another area where investment outlays can be large. Our own expectation is that the company's capital commitment will be restricted, and they would be seeking a co-developer who can make suitable investment contributions for implementation of the entire project. Investment commitments in excess of US$100 million to these projects could pose a risk to our positive investment thesis.

Valuation and share price analysis

Performance and valuation of global peers

Recent economic events in the US have had a significant influence on the performance of luxury good and jewelry retailers. However, most companies have recovered significantly from their January lows, indicating that consumer demand will show improvement in 2HCY08/CY09. In fact, Swatch recently guided that sales in the US remain strong in the mid-to-high price ranges. Earlier in the year, jewelry retailers in the US were also impacted by the bankruptcy announcement of Friedman. Friedman is currently engaged in inventory sale under court supervision, but stock price performance of other retailers such as Zales and Signet hold steady.

Luxury good companies are currently trading at a P/E multiple of 14x and EV/EBIDTA multiple of 8x. US jewelry retailers are trading at a P/E multiple of 13x and EV/EBIDTA multiple of 6.5x.

Table 5: Share price performance for global jewelry and luxury good companies

		Absolute				Relative			
	Price (LC)	1M	3M	6M	12M	1M	3M	6M	12M
Bulgari	6.855	-4%	-18%	-40%	-38%	-8%	-7%	-28%	-28%
Burberry	412.75	-6%	-15%	-38%	-40%	-10%	-3%	-26%	-30%
Christian Dior	66.48	-2%	-18%	-26%	-28%	-7%	-7%	-12%	-17%
Hermes	76.82	0%	9%	-14%	-28%	-5%	24%	3%	-16%
LVMH	67.52	2%	-10%	-21%	-21%	-3%	2%	-6%	-8%
Swatch	254	-14%	-13%	-32%	-24%	-18%	-1%	-19%	-12%
Tiffany & Co	41.21	15%	2%	-27%	-15%	8%	7%	-15%	-10%
Zale	18.81	5%	31%	-24%	-32%	-2%	37%	-13%	-27%
Signet	67.5	23%	21%	-28%	-46%	15%	27%	-17%	-42%
Chow Sang Sang	9.23	13%	-24%	-21%	68%	6%	-14%	-7%	41%
Luk Fook	4.42	-16%	-39%	-30%	37%	-21%	-32%	-18%	15%

Source: Bloomberg.

Table 6: Global luxury goods companies—Valuation table

	Bloomberg		Mcap	P/E		EV/EBITDA		EV/Sales	
	ticker	Price (LC)	US$MM	2008E	2009E	2008E	2009E	2008E	2009E
Bulgari	BUL IM	7	3,273	12.6	11.0	9.5	8.4	1.9	1.8
Burberry	BRBY LN	413	3,537	11.6	9.6	7.0	6.0	1.7	1.5
Christian Dior	CDI FP	66	19,207	10.3	8.8	3.8	3.4	1.0	0.9
Hermes	RMS FP	77	12,957	26.7	23.7	14.8	13.3	4.3	3.9
LVMH	MC FP	68	52,595	14.0	12.4	8.0	6.9	2.0	1.8
Swatch	UHR VX	254	14,494	12.9	11.5	7.6	6.9	2.0	1.8
Tiffany & Co	TIF US	41	5,196	15.5	13.9	8.0	7.2	1.8	1.6
Zale	ZLC US	19	804	NM	18.4	11.0	6.3	0.5	0.5
Signet	SIG LN	68	2,280	13.1	13.0	6.8	6.8	0.8	0.8
Chow Sang Sang*	116 HK	9	713	9.4	8.3	6.6	5.4	0.6	0.5
Luk Fook*	590 HK	4	279	7.4	6.4	4.6	3.9	0.6	0.5

Source: JPMorgan estimates. * Bloomberg consensus estimates. Note: Share price and valuations are as of 10 April 2008.

Performance and valuation of domestic peers

Given the multiplicity of growth drivers, there are no strict comparables to Gitanjali in the domestic market. Titan (Overweight) and Rajesh Exports (Not Rated) are close comparables that are engaged in the jewelry business. The performance of both these stocks has not been very different from that of Gitanjali. After outperforming the benchmark in 2007, they have underperformed significantly in 1QCY08. We remain positive about the prospects for branded jewelry companies and expect them to gain share from the unorganized sector. As the business models are still not mature, we prefer to use the P/E, PEG and EV/EBIDTA approach for valuing these companies. We are currently valuing Titan using a forward P/E multiple of 25x, which reflects a premium of 50% premium to the benchmark and is a reflection of the higher earnings growth trajectory.

Table 7: Domestic valuation table

	Bloomberg ticker	Price (Rs)	Mkt cap US$MM	P/E 2008E	P/E 2009E	EV/EBITDA 2008E	EV/EBITDA 2009E	EV/Sales 2008E	EV/Sales 2009E
Titan	TTAN IN	1,066	1,185	23.1	16.9	14.8	10.6	1.3	1.0
Gitanjali Gems	GITG IN	227	610	11.9	8.8	8.6	7.1	0.5	0.5
Rajesh Exports*	RJEX IN	92	575	7.8	5.3	6.0	5.0	0.3	0.3

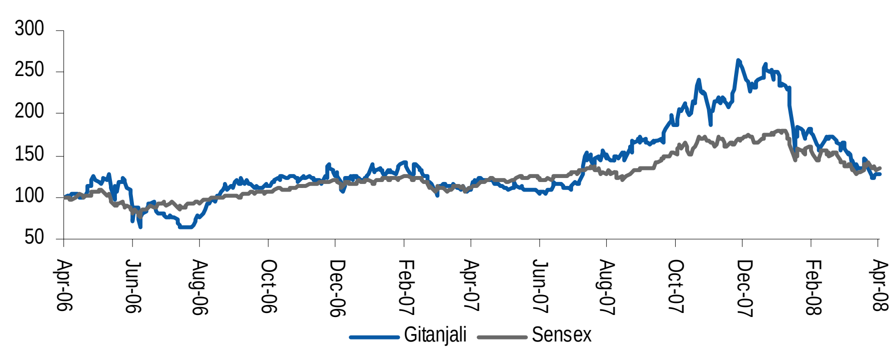
Source: JPMorgan estimates. * Bloomberg consensus estimates. Note: Prices and valuations are as of 10 April 2008.

Stock price performance of Gitanjali Gems

Post its listing in March 2006, Gitanjali underperformed the market due to concerns raised about the diamond processing business facing intense competition and margins coming under pressure. There were also concerns relating to the jewelry demand slowdown in the US markets. However, as the company reported strong revenue and profit growth along with improved margins, these concerns subsided and the share price performance improved substantially from June 2007. Renewed concerns of slowdown in India and the US have impacted stock price performance since December 2007, and the stock has significantly underperformed the benchmark.

We believe these concerns will subside as we remain confident about the business prospects of the branded jewelry operations of the company. The international strategy also has been misunderstood to some extent. A large part of the payback of the international acquisitions is from the value chain, and we do not envisage any major difficulties in achieving those targets. The Hyderabad SEZ will also move into operational phase over the next 2-3 months, and a possible tie-up with a co-developer could help in unlocking value and improving pace of execution.

Figure 6: Relative share price performance



Source: Datastream.

Valuations for Gitanjali Gems

In comparison to its peers, Gitanjali's stock trades at a discount to the P/E and EV/EBIDTA multiples. This discount, to some extent, reflects the transitionary business model of the company as it seeks to increase the share of the higher margin jewelry business compared to the low-margin diamond cutting business. We also expect its ROE and ROCE to show improvement with increased share of jewelry in the overall business.

Given the multiple growth drivers and the fact that the business model is still not mature, we prefer to use a sum-of-the-parts approach. Using some conservative EV/EBIDTA valuation multiples for the jewelry business and DCF value for the SEZ, our target price for the company is Rs400. Our price target implies an EV/EBIDTA multiple of 9x and a P/E multiple of 12.5x for the core business based on our FY10 estimates.

Table 8: Gitanjali Gems—Sum-of-the-parts valuation
Rs in millions

Segment	EV/EBITDA (x)	Value
Diamond	5	5,825
Jewelry	10	30,534
International	6	2,933
Total		39,292
SEZ		7,995
Total		47,287
Net Debt		5,219
Market cap		42,068
Per share (Rs)		391
No. of shares (MM)		108

Source: JPMorgan estimates.

Table 9: Share price sensitivity to earnings and valuation multiple
Rs

Valuation multiple / change in earnings	-10	-5	0	5	10
-10	322	338	355	371	388
-5	338	356	373	390	408
0	355	373	391	410	428
5	371	390	410	429	448
10	388	408	428	448	468

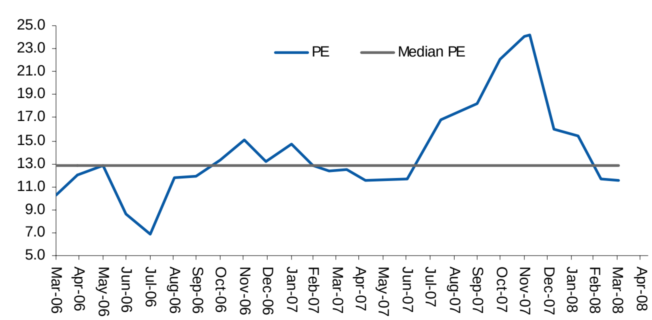
Source: JPMorgan estimates.

Table 10: Hyderabad SEZ—DCF valuation
Rs in millions

		FY09	FY10	Terminal
Area (sq ft)				
Processing Zone		433,422	1,733,688	8,668,440
Non Processing		-	544,500	15,770,210
Rentals (Rs/sq ft pm.)				
Processing Zone		25	26	5% p.a growth
Non Processing			30	5% p.a. growth
Income (Rs MM)				
Processing Zone		130	546	3,319
Non Processing		-	196	4,713
Total		130	742	8,032
Capital and maintenance cost (Rs MM)				
Processing Zone		433	1,300	
Non Processing Zone		0	708	
Maintenance Cost		11	57	486
Total Costs		444	2,065	486
Initial Costs	(1,089)			
Present Value	(1,274)			
Terminal Value	10,358			
NPV of SEZ	7,995			

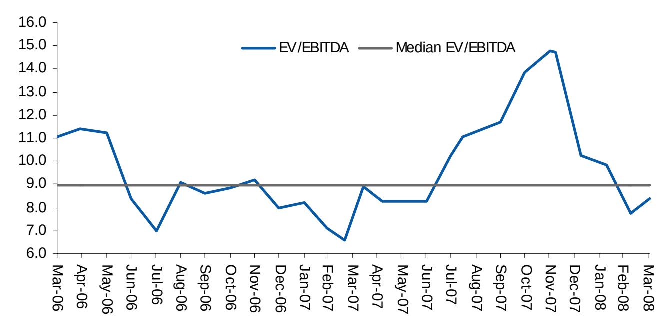
Source: JPMorgan estimates.

Figure 7: Gitanjali—Rolling one-year forward P/E



Source: Company, Datastream, and JPMorgan estimates.

Figure 8: Gitanjali—Rolling one-year forward EV/EBITDA



Source: Company, Datastream, and JPMorgan estimates.

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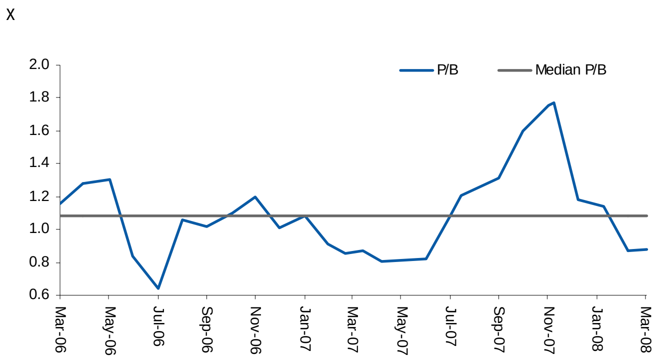
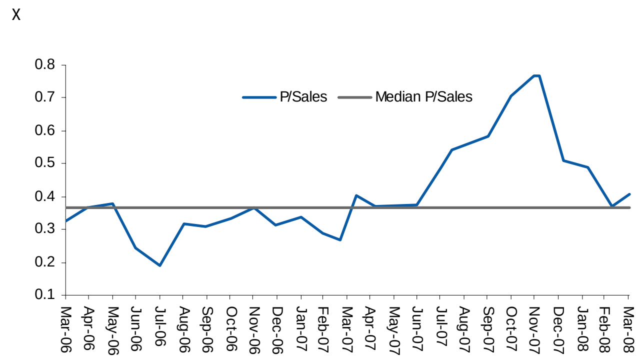
Figure 9: Gitanjali—Rolling one-year forward P/B



Source: Company, Datastream, and JPMorgan estimates.

Figure 10: Gitanjali—Rolling one-year forward Price/sales



Source: Company, Datastream, and JPMorgan estimates.

Key risks

Key risks to Gitanjali's growth and valuations, in our view, are: (1) any significant decline in consumption which also has an impact on discretionary spending such as jewelry, (2) any policy/taxation/legislative changes which impact the diamond processing and jewelry business could impact earnings, and (3) the company might continue pursuing an inorganic growth strategy for expansion in the overseas market. Considering limited experience in managing retail operations and uncertain growth outlook, there could be a potential acquisition risk which could impact the company.

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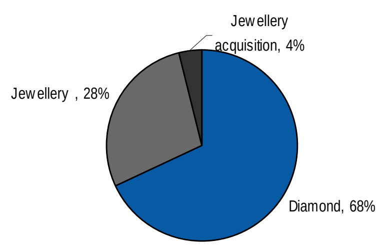
Company description

Background and overview

Established in 1986, Gitanjali Gems is one of the largest integrated diamond and jewelry manufacturing companies in India with 2,400 full time and 1,500 contract employees. Its operations include cutting and polishing rough diamonds sourced from suppliers in international markets, mainly for exports and the manufacture and sale of diamond jewelry in India and international markets. Its retail sales and distribution network consists of 112 distributors and 1,250 outlets in India.

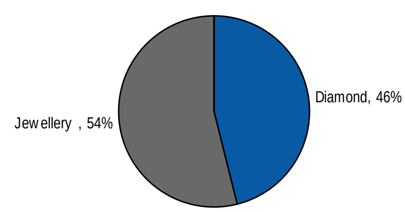
In December 2006, the company acquired an 84% equity stake in Samuels which operates 97 stores in the US. It intends to increase its equity stake to 97% by December 2008. In December 2007, the company expanded its portfolio by acquiring Rogers which operates 46 stores and has sales of US$80 million. Key export markets include the US, Europe, the Middle East, Japan, China, Hong Kong, and Thailand. In FY07, diamonds accounted for 68% of the revenues and 46% of the operating profit whereas jewelry accounted for 32% of sales and 54% of the operating profit.

Figure 11: Gitanjali—Revenue break-up (FY07)



Source: Company.

Figure 12: Gitanjali—EBIT break-up (FY07)



Source: Company.

Table 11: Gitanjali—Margin profile for key business segments

	Gross margin	Net margin
Diamond	8-10%	2-3%
Jewelry exports	18-20%	12%
Jewelry retail	30-35%	10%

Source: Company, JPMorgan estimates.

Experienced management

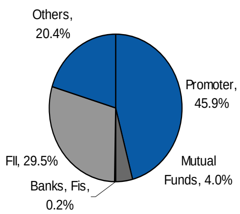
Gitanjali Gems has a well qualified senior management team with significant industry experience. Mr. Mehul Choksi, chairman and managing director, has been associated with the gems and jewelry industry for over three decades and has exposure to the entire range of activities in this industry. He has played a pivotal role in shifting the company’s focus from a diamond processing company to jewelry manufacturing and retailing. He now intends to expand the scope of his business by aiming to make a strong presence in international markets and also exploring the lifestyle retailing segment.

Mr. G.K. Nair, executive director, has been associated with the company for the last nine years and oversees the finance and accounting functions. He is also responsible for shaping the corporate strategy and identifying global opportunities for the company.

Mr. Adrianus Voorn, executive director, is in charge of manufacturing operations. He has previously worked with large corporations in Europe and Asia and has been responsible in setting up various diamond processing and jewelry manufacturing plants.

Mr. Dhanesh V. Sheth has been associated with the company for the past two decades and has been a key advisor for its marketing operations and new business development in the jewelry space.

Figure 13: Shareholding pattern (Dec'07)



Source: BSE.

Corporate structure

Key subsidiaries and associates of the company include:

(1) *Gitanjali Exports Corporation Limited:* It manufactures and exports cut and polished diamonds and trades in rough diamonds.

(2) *Gili India:* Gitanjali currently owns a 100% stake (65% in January 2008); it manufactures and sells jewelry under the '*Gili*' brand.

(3) *D'Damas Jewelry:* Earlier a joint venture with Damas, a large Dubai-based jewelry group, it became a 51% subsidiary in May 2007. This company is involved in manufacturing gold and diamond jewelry.

(4) *Brightest Circle:* Gitanjali holds a 100% stake (33% in January 2008) stake in this company. It sells diamond jewelry under the '*Nakshatra*' brand.

(5) *Hyderabad Gems SEZ:* This is a 100%-owned subsidiary which is developing the Hyderabad SEZ.

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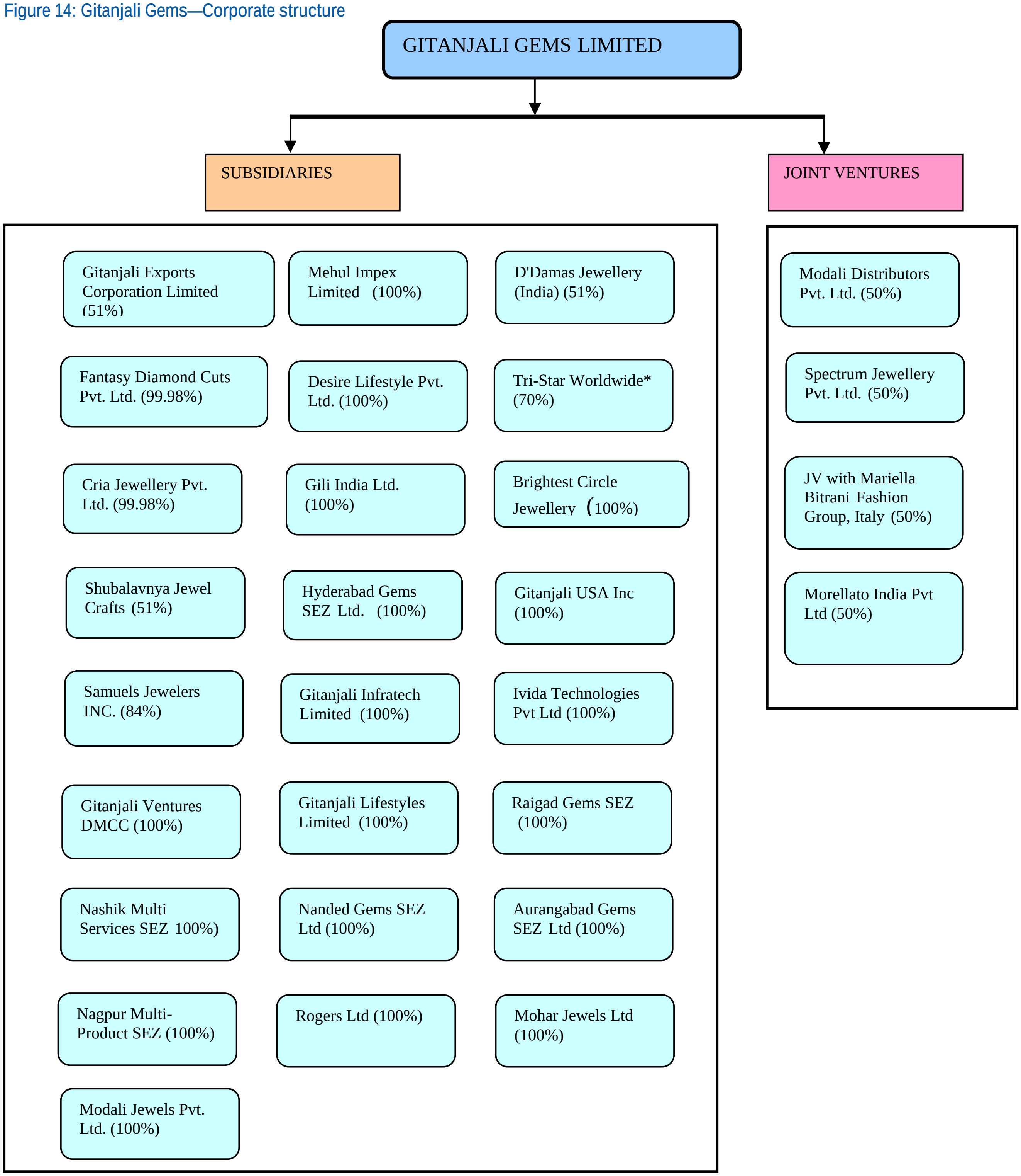
Figure 14: Gitanjali Gems—Corporate structure



Source: Company. *- Held through Gitanjali USA, Inc.

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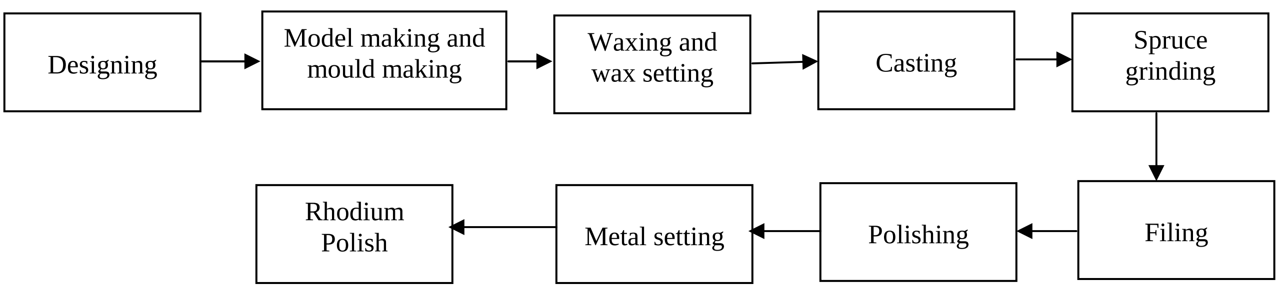
Manufacturing facilities

Currently, Gitanjali has two diamond processing facilities located at Borivali in Mumbai and Surat in Gujarat. It also has a large jewelry designing and manufacturing facility at SEEPZ in Mumbai which is entirely export-oriented. The company also has two jewelry manufacturing units for the Indian operations in Andheri, Mumbai. In addition, it has five small jewelry manufacturing facilities in an SEZ in Surat, Gujarat.

Besides these, management intends to start five diamond and jewelry manufacturing facilities in its Hyderabad SEZ. One of these would commence full operations by June 2008 while the other four would be operational in the next 6-12 months.

Figure 15: Jewelry manufacturing process



Source: Company.

Leading brands

Gitanjali enjoys strong brand presence in its domestic jewelry retail operations. It sells its products under various brands like *Asmi*, *Sangini*, *Gili*, *Nakshatra* and *D'damas*. Gitanjali has recently launched its plain gold jewelry brand called "*Maya Gold*", which it plans to retail via its existing distribution network. The company has also entered into various alliances with foreign luxury good companies to retail their brands through its lifestyle stores in India

Table 12: Leading jewelry brands of Gitanjali Gems

Brand	% ownership	Description
Asmi	100%	Premium work wear collection
Sangini	50%	Entire product range including bridal jewelry
Nakshatra	100%	Entire product range including bridal jewelry
Gili	100%	Diamond jewelry at reasonable prices
Vivaaha	100%	Wedding jewelry
Maya	100%	Gold jewelry for wedding and other similar events
D'damas	51%	International quality designs combined with Indian values

Source: Company, JPMorgan.

Table 13: Gitanjali—Key lifestyle brands to be retailed

Company	Products/Category	Key brands
Trinity Watch Company (Acquired)	Watches	Iris, Saint Hanore, Umbro , Everest
Hoop Silver Jewelry (Acquired)	Fashion jewelry	Hoop
MoU with Mariella Bitrani Fashion Group, Italy	Luxury goods	Mariella Burani, Baldinini, Rosato, Calgaro and Facco
Morellato India Pvt Ltd	Watches, leather goods, writing instruments, jewelry	Morellato, Miss Sixty, Just Cavalli, Molecole, John Galliano, Roberto Cavalli, Philip Watch, Pirelli, Pirelli Pzero, Sector, Moschino

Source: Company.

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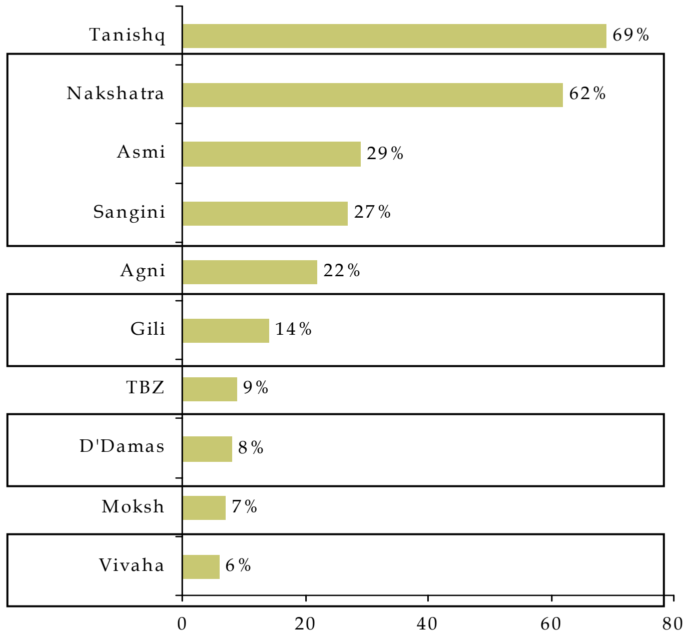
Figure 16: Strong brand recall for Gitanjali Gem's leading brands



Source: The Solitaire – TNS Survey 2005.

Widespread retail distribution network

Gitanjali Gems has a multi-channel distribution network, selling its jewelry products through 1,389 outlets currently. About 40-45% of the company's sales occur through exclusive distributors (112 currently), which sell the products through local jewelers. About 20-25% of the sales occur through shop-in-shops in various department stores, such as Globus, Lifestyle, and Westside. The remaining sales happen through the company-owned or franchisee stores. The commission, in the range of 15-25%, is given to distributors and franchisees, and the inventory remains on the company's books. It follows a strict policy for store operations, wherein a store is closed if it is unable to achieve targeted revenues in one year of its operations.

Table 14: Jewelry retail distribution channels

Brand	Exclusive stores	Retailers	Shop in malls	Franchisee	Total
Gili	3	130	123	-	256
Asmi	2	102	-	-	104
Nakshatra	-	374	-	1	375
Sangini	-	69	5	6	80
D'damas	2	380	3	21	406
Desire Lifestyle	-	12	10	-	22
Gitanjali	3	-	-	-	3
Samuels	17		80	-	97
Rogers	46				46
Total	73	1,067	221	28	1,389

Source: Company.

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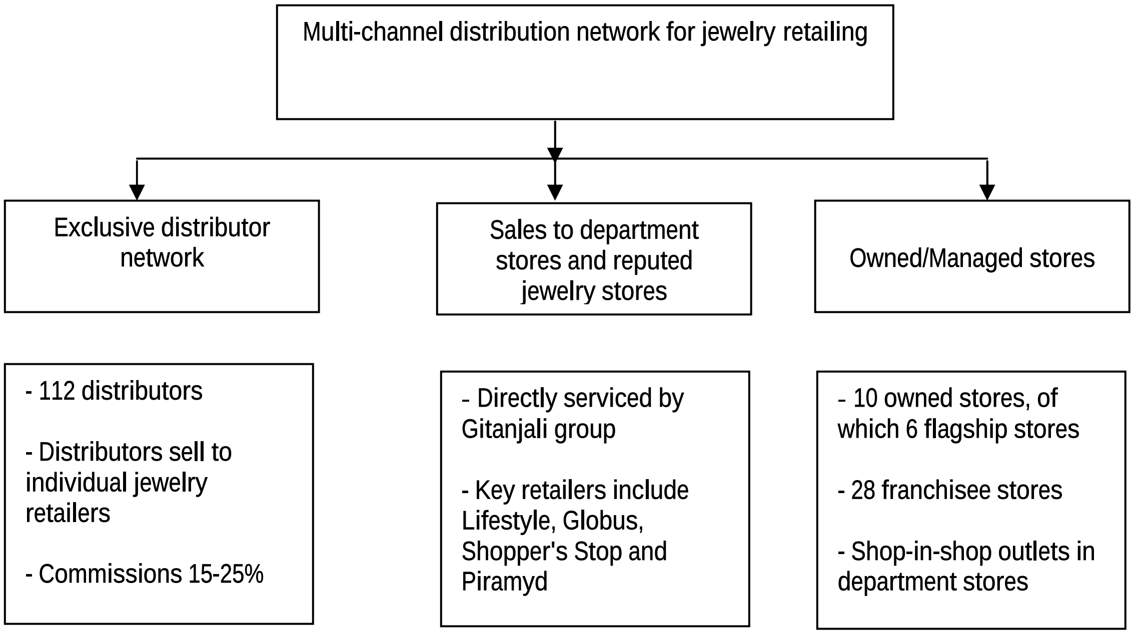
Figure 17: Distribution network for Gitanjali's domestic retailing business



Source: Company.

SEZ operations

Gitanjali has made a foray into SEZ operations through a dedicated gems and jewelry SEZ at Hyderabad. Considering the resource, design, and manufacturing base in the country for jewelry, we believe this move provides an excellent opportunity to create value.

The Hyderabad SEZ is spread across 200 acres, and so far, approximately 170 acres of land has been allotted to the company to be developed exclusively for the gems and jewelry sector. Of the 200 acres of land, about 125 is likely to be developed which will be equally divided for manufacturing and commercial usage. The facilities in this zone would avail various tax and custom duty benefits. Higher operating margins, to the extent of 90%, are expected from this SEZ from where the company will earn mostly rental income.

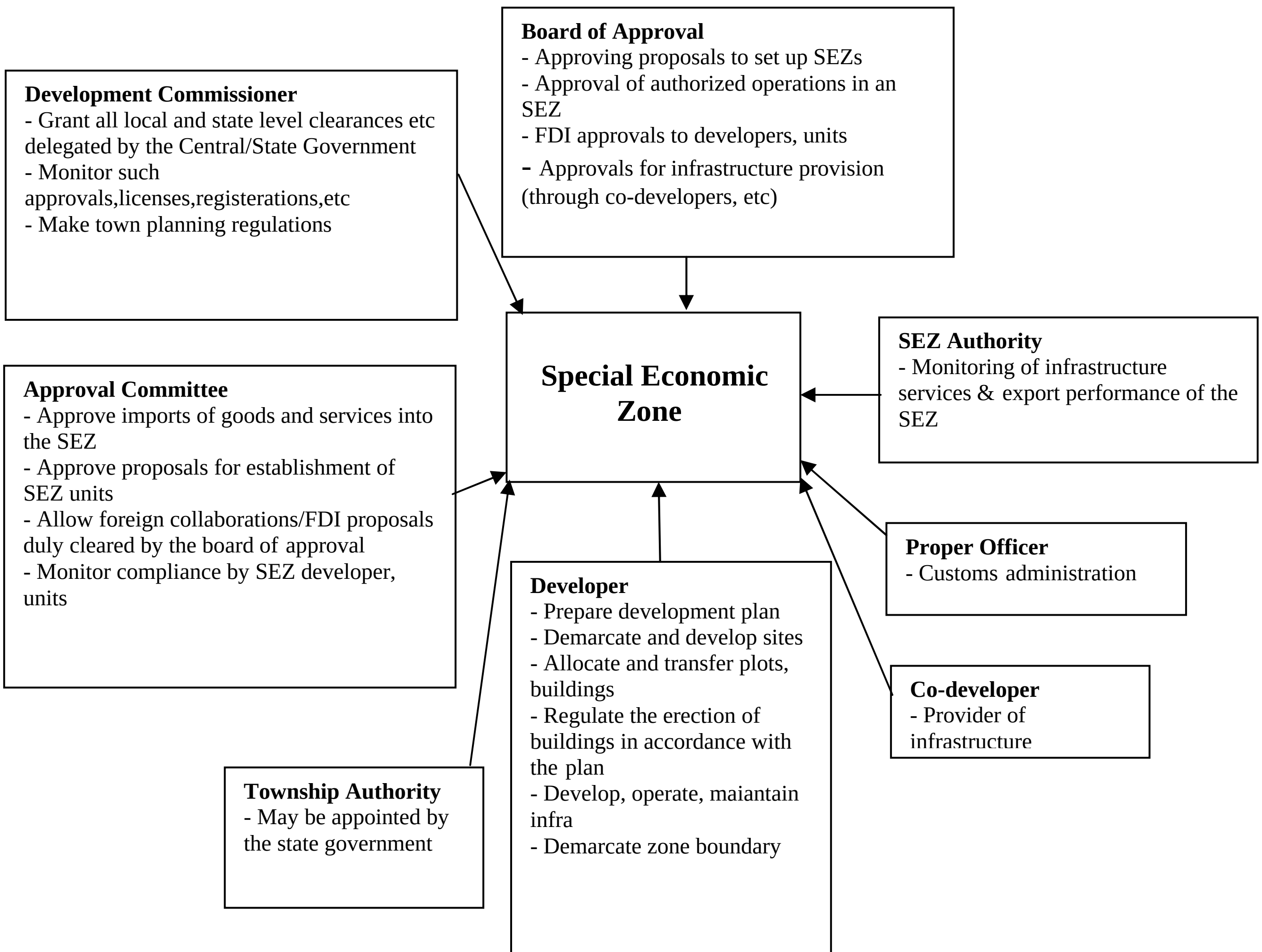
Gitanjali will set up five diamond and jewelry manufacturing facilities for its own use. One of these facilities would commence commercial production by June 2008 with four others expected to commence operations next year. Skilled labor is the key requirement for a diamond and jewelry manufacturing hub and a dedicated training centre for the same is already set up with a present capacity to train up to 1,200 workers. Besides the Hyderabad SEZ, the company is also in the process of establishing five other SEZs, details of which are mentioned in the table below. We believe that the company would be looking at partnerships to scale up this business in order to ensure timely execution and mitigate risk.

Table 15: Gitanjali Gems—SEZ operations

Location	Sector	Area (hectares)	Approval status
Raigad	Gems & jewelry	10.2	Formal approval received from central government
Aurangabad	Gems & jewelry	50	In-principle approval received from state government
Nanded	Gems & jewelry	50	In-principle approval received from state and central government
Nashik	Multi services	100	In-principle approval received from state and central government
Nagpur	Multi product	1,000	In-principle approval received from state government

Source: Company reports.

Figure 18: SEZ—Institutional framework



Source: IL&FS.

Key shareholders

As of December 2007, Mr. Mehul Choksi and the Choksi family are the key promoters of Gitanjali with a stake of 45.9%. The FIIs, as a group, are the other large shareholders in the company with a stake of nearly 30%, while public and other retail shareholders have a stake of 20.4%.

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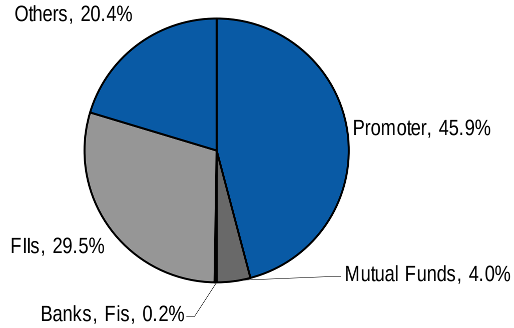
Shareholding pattern

Figure 19: Shareholding pattern (as on December 2007)



Source: BSE.

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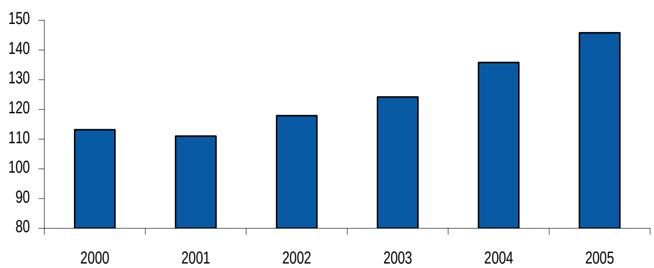
Industry analysis

Global markets have seen steady growth

Although slowdown concerns are dominating the market, over the longer term the jewelry markets have been able to maintain steady growth. The market size for global gems and jewelry industry is estimated at about US$146 billion, growing at 5-7% p.a. Diamond jewelry accounts for the largest share at 47%, followed by plain gold jewelry at 42%. Over the past few years, sales growth for plain gold jewelry has been higher than diamond as gold prices have strengthened significantly. In terms of jewelry consumption, the US tops the chart with 31% share followed by the Middle East and China at 9% each and India at 8%.

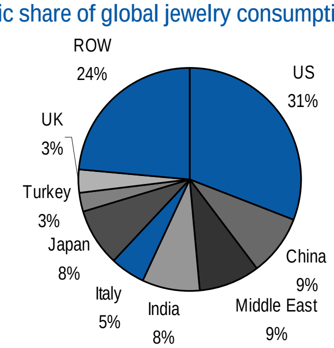
Figure 20: Global jewelry sales

US$ in billions



Source: GJPEC.

Figure 21: Geographic share of global jewelry consumption (2005)

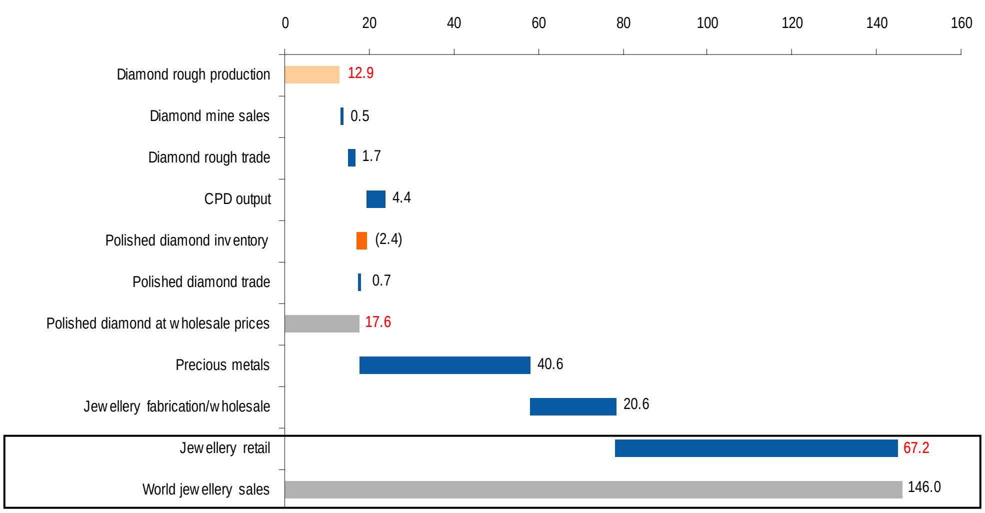


Source: GJPEC.

Jewelry manufacturing goes through a series of processes, and we find that value addition is higher towards the beginning and end of the chain (see Figure 22). Jewelry retailing accounts for a maximum 46% share of the value chain.

Figure 22: Global gems and jewelry value chain (2005)

US$ in billions



Source: GJPEC, KPMG.

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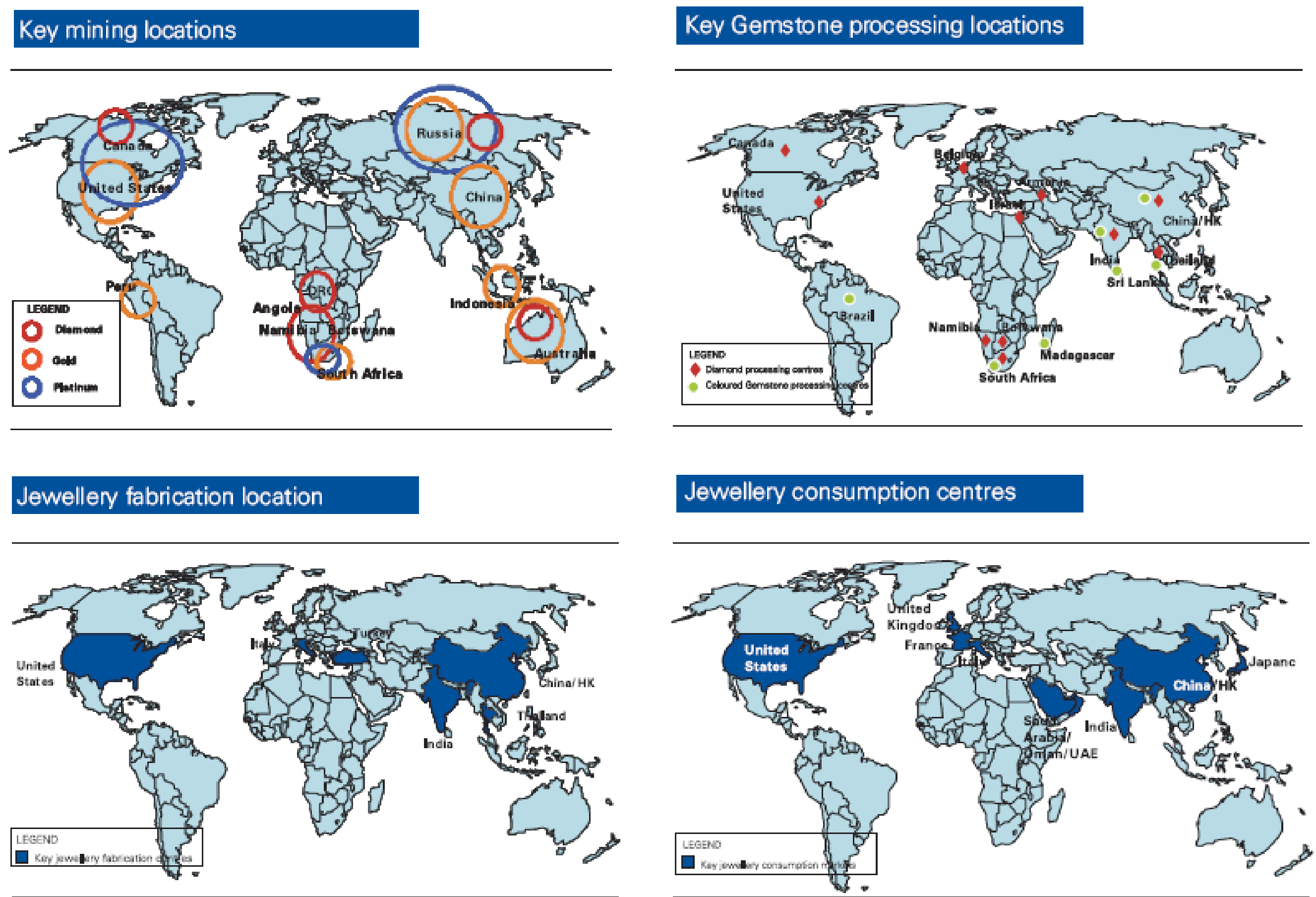
Figure 23: Global spread of gems and jewelry industry

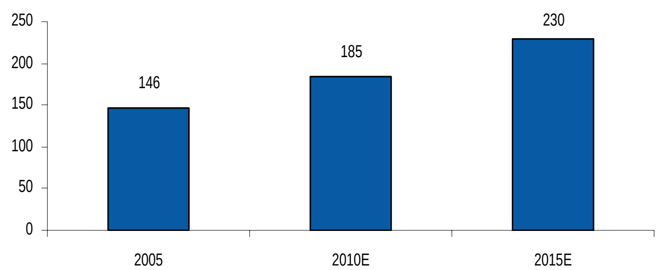


Source: GJPEC, KPMG.

A recent study by GJPEC and KPMG estimates global jewelry sales to show a CAGR of 4.6% over 2005-15. With slower growth for diamond jewelry (3.3%), it expects the share of diamond jewelry in the overall gems and jewelry sales to decline from 47% currently to 41% by 2015. Further, it estimates jewelry sales to grow significantly in China and India, with their share of total consumption rising to 13% and 12%, respectively, by 2015.

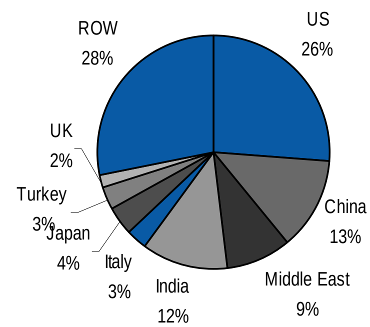
Figure 24: Projected global jewelry sales

US$ in billions



Source: GJPEC, KPMG.

Figure 25: Projected share of key markets for jewelry consumption by 2015



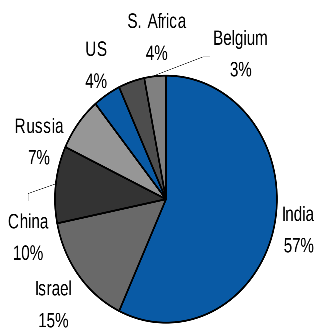
Source: GJPEC, KPMG.

Indian gems and jewelry market

India continues to remain the leader in diamond processing

India is the largest diamond cutting and polishing country, accounting for 57% share in value terms and 80% share in volume terms globally. It dominates the low value smaller-size diamond segment and is now steadily consolidating its position in the larger size segment. The diamond processing industry remains highly fragmented in India with over 100,000 units. Rough diamonds are procured from a few major diamond mining companies worldwide. DTC, the marketing arm of De Beers, is the largest diamond distributor and accounts for nearly 50% of the global diamond distribution.

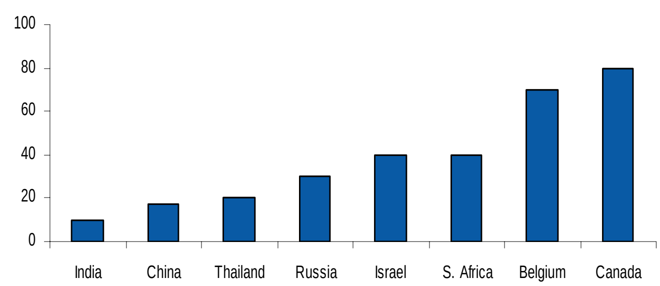
Figure 26: Output of key diamond processing nations (value)



Source: GJPEC.

Figure 27: Cost of processing diamond—A comparison

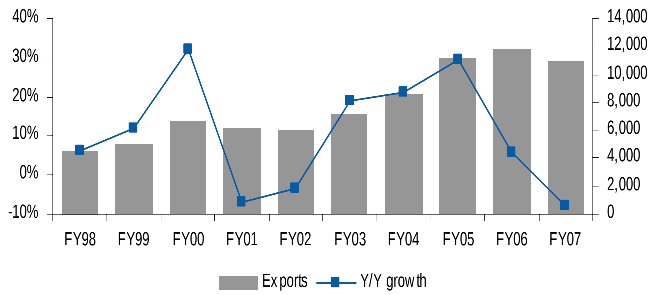
US$/carat



Source: KPMG, GJPEC.

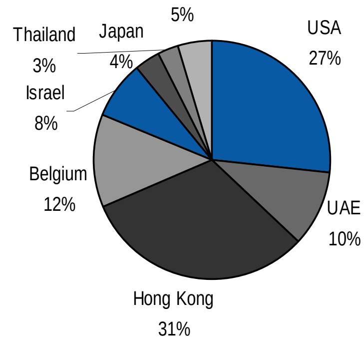
Labor cost for processing diamonds remains the lowest in India and has been the key reason for its dominance in this segment. However, this dominant status is now being challenged by emerging destinations for diamond processing such as China and the African nations. Exports of cut and polished diamonds from India amounted to US$11 billion during 2006-07, with Hong Kong and the US accounting for the largest share at 31% and 27%, respectively.

Figure 28: Exports of cut and polished diamonds from India
US$ in millions



Source: GJPEC.

Figure 29: Destination-wise exports of cut and polished diamonds from India

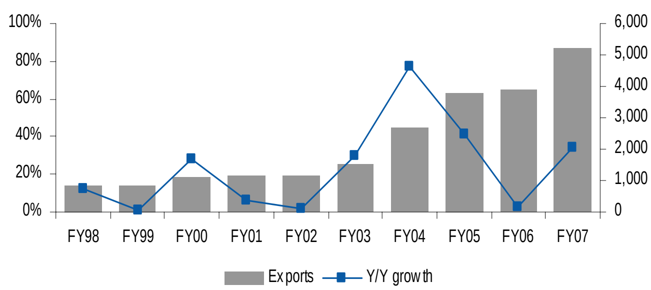


Source: GJPEC.

Jewelry export growth trends have been strong

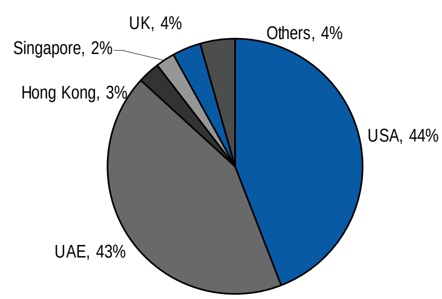
India is a key jewelry manufacturing hub with a presence of rich craftsmanship and low cost of labor. It has manufacturing capabilities in almost all types of jewelry (gold, diamond, gemstone). Jewelry exports have been growing at a strong pace, registering a CAGR of 35% over the last five years. The US and the UAE are the key export markets, accounting for nearly 87% of the total gold jewelry exports from the country.

Figure 30: Exports of gold jewelry from India
US$ in millions



Source: GJPEC.

Figure 31: Destination-wise exports of gold jewelry from India



Source: GJPEC.

Exciting growth outlook for branded jewelry in India

The jewelry market is amongst the fastest growing sectors in India with the gold jewelry segment growing at 15% p.a. and the diamond jewelry market registering growth rates upwards of 25% p.a. India is the largest consumer of gold globally and the market size is estimated at US$12 billion, of which gold jewelry commands a major share of 80%. The unorganized sector, largely family jewelers, dominates this market with almost 97% share.

Although people have expressed slowdown concerns, we remain positive about the branded jewelry space, which has been growing at 25-30% p.a., keeping pace with the rapid growth in organized retailing in India. There is increasing inclination to purchase branded jewelry which offers guarantee and assurance of good quality. The rising number of working women with increasing fashion awareness is contributing to higher spending on branded jewelry. More players are entering this space, introducing new concepts. Further emergence of new retail formats, such as department stores, boutiques and gold souks, and rising 'impulse purchases' will

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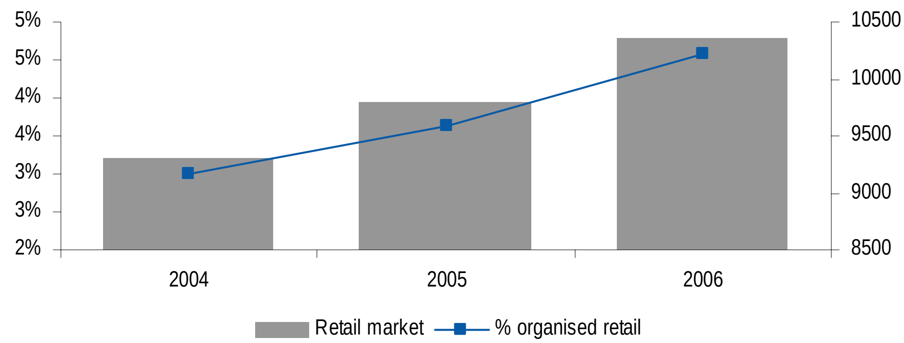
push this growth forward, in our opinion. The luxury segment is a key customer for jewelry in India as 27% of market spending in this segment is on jewelry. Key branded jewelry retail players are Titan (*Tanishq*), Damas, and Gitanjali Gems.

Figure 32: India jewelry retail market
Rs in billions, %

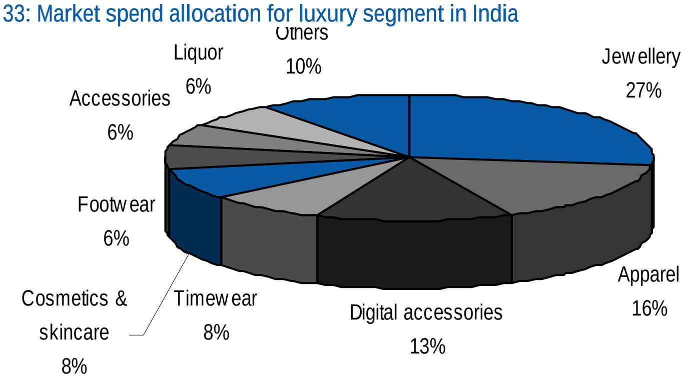


Source: India Retail Report.

India luxury retail market

The potential for luxury retailing in India is large considering that Indians attach significant importance to brands. KSA Technopak estimates the market size at US$500 million and is growing at a rate of 35-40% p.a. The luxury watch market and branded jewelry each are growing at 40% p.a., wine at 30%, and international travel at 35%.

Figure 33: Market spend allocation for luxury segment in India



Source: KSA Technopak.

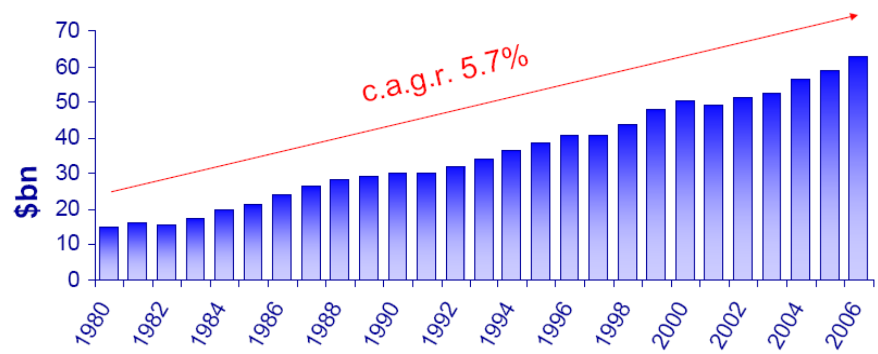
Lifestyle and attitudinal changes, consumerism, and rising income levels will continue to provide growth momentum to the high-end brand retailing in the country. According to a recent industry report, there are about 1.6 million luxury households in India and this number is likely to cross 3 million by 2010. Each of these households earns about over US$100,000 per year and they spend about US$9,000 per year on luxury and high-premium goods and services. Further, in 2005, there were 83,000 millionaires (individuals with financial assets of US$1 million or more) in India, and this number is expected to grow 12.8% annually by 2009.

Lack of proper retail infrastructure has been a key concern for the growth of this segment, which has so far largely been restricted to five-star hotel premises. However, this scenario is slowly changing with the development of luxury floor spaces within various upcoming malls. This will further benefit the growth of luxury retailing in the country. High tariffs on luxury goods to the extent of 40% (10% peak duty + countervailing and special duty) also impact the demand for such goods. In case of liquor, the duties are as high as 300-500%.

US jewelry retail market

Jewelry sales in the US, including watches and fashion jewelry, amounted to US$65 billion in 2007, up 4% Y/Y. The jewelry retail market in the US is highly fragmented and jewelry is sold through various formats such as department stores, discount stores, internet retailers, TV home shopping, and specialty stores. Wal-Mart is the largest jewelry retailer in the country, accounting for 4.6% market share, followed by Signet at 4.2%. Specialty retailers account for 48% of total jewelry sales and consolidation has been happening in this space. According to the Jewelers Board of Trade, there were 23,778 specialty jewelry firms in the US in 2006 compared to 25,753 in 2001 and 28,302 in 1996. Diamond jewelry accounts for 55% of total jewelry sales in the US market. It has grown at a CAGR of 6.4% over the past ten years compared to the 4.5% industry growth. Although recession concerns have increased significantly, we are confident that the sector would be able to ride through these and achieve normalized growth in 2HCY08 and CY09.

Figure 34: US jewelry and watch market
US$ in billions



Source: US Department of Commerce, Signet.

Table 16: US jewelry market structure

	2003	2006
US market size (US$ B)	54	63
Independent jewelers	36%	33%
Chain jewelers ($100MM+ sales)	14%	15%
Total specialty	50%	48%
Chain department stores	12%	12%
Mass merchants	10%	10%
TV Home Shopping	4%	5%
Others	21%	21%
Total non-specialty	47%	48%
Internet sales	3%	4%
Total	100%	100%

Source: National jeweler, Signet.

Table 17: Growth in US jewelry market share

	1999	2005	2006
Signet US	5.2%	8.2%	8.8%
Zale Corp US	6.5%	7.8%	7.4%
Chains ranked 3 - 7	9.5%	10.1%	NA
Chains ranked 8 - 15	5.1%	4.2%	NA
Other specialty jewelers (sales <$100MM)	73.7%	69.7%	NA

Source: Signet presentation.

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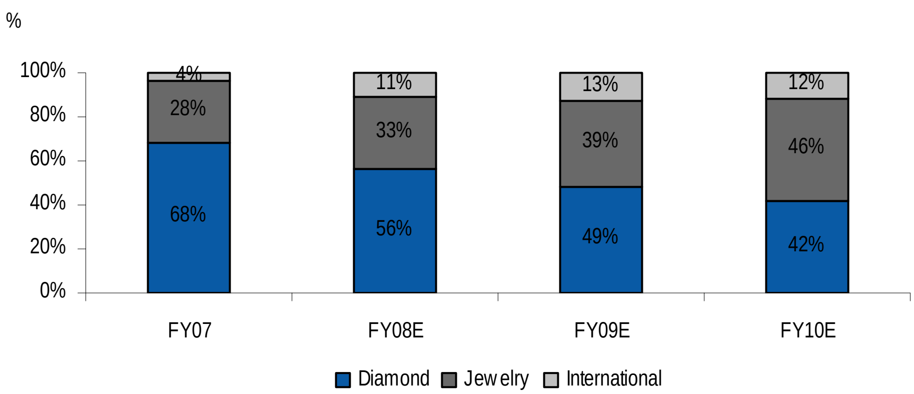
Financial analysis

Jewelry sales to drive top-line growth

The revenue mix for Gitanjali Gems is steadily shifting from diamond processing to jewelry sales. Diamond processing, which accounted for a majority share (85%) of revenues in FY06, saw a decline to 68% in FY07. We expect this share to further come down significantly to nearly 42% by FY10, according to the company's strategy to enter high-value added operations of jewelry manufacturing and retailing. We assume 5-6% revenue growth for the diamond processing business given that diamonds would be increasingly used in-house for jewelry operations and exports would take a back seat.

We estimate revenue from domestic jewelry and lifestyle operations to grow at a CAGR of 53% from FY08-10E, driven by 90% growth in jewelry and lifestyle retail sales on account of new store openings, healthy same-store sales growth, and rising contribution from gold jewelry brands like *Maya* and *Collection G*. Jewelry exports and wholesale, too, will contribute significantly to overall growth, with sales for these segments rising by 20% and 50%, respectively, over FY08-10E. We expect international operations to contribute more than 12% to the company's top line.

Figure 35: Revenue share trends



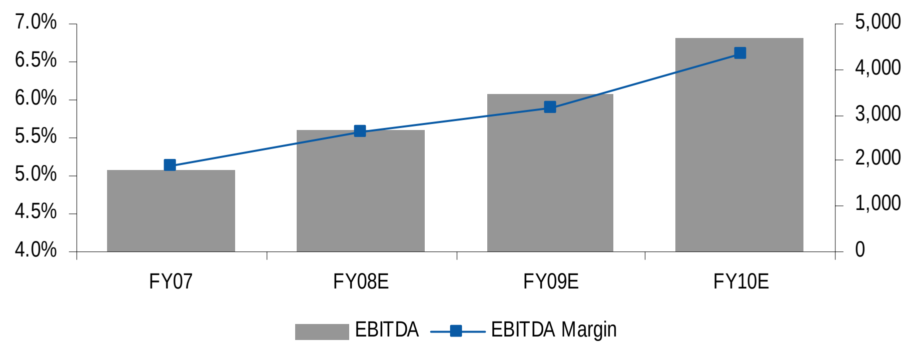
Source: Company reports and JPMorgan estimates.

Margin expansion holds the key for earnings CAGR of 33% during FY08-10E

The rising share of jewelry sales (domestic and international) in the overall revenue mix would result in steady margin expansion over the coming years. Compared to the diamond processing margins of 3-4%, jewelry operations enjoy higher blended margins of 9-10%, and we expect EBITDA margins to expand by 100bp over FY08-10E, in line with the rising share of jewelry sales (Figure 36).

Figure 36: EBITDA profit and margin trends (consolidated)

%

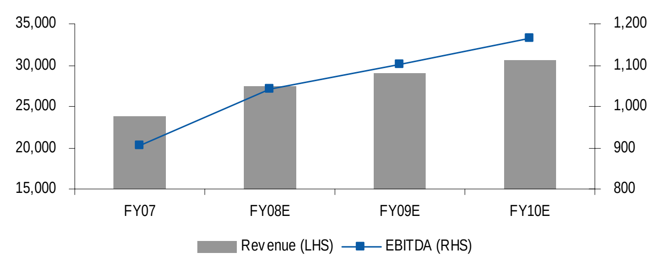


Source: Company reports and JPMorgan estimates.

For the diamond business, operating margins at 3-4% face no pressure from the appreciating currency as the company does not follow a cost-plus model for this business. The company procures significant quantities of rough diamonds from DTC, with which it enjoys sightholder status, ensuring steady supply of rough diamonds at competitive prices, advertising and marketing support from DTC, and access to DTC's consumer research knowledge base. We assume steady margin trends for jewelry exports at 17% over the next two years. We expect margins for jewelry wholesale to improve from about 3% currently to 4% over the next two years, as jewelry manufacturing for this would become in-house, with new facilities coming up in Hyderabad.

Figure 37: Revenue and EBITDA trends for diamond business

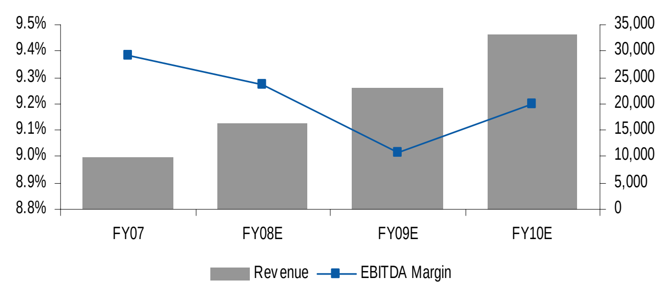
Rs in millions



Source: Company reports and JPMorgan estimates.

Figure 38: Revenue and margin trends for jewelry business

Rs in millions, %



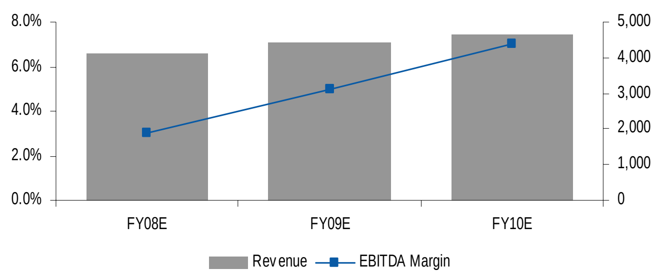
Source: Company reports and JPMorgan estimates.

For the domestic jewelry retail business, we expect operating margins to rise from 7% in FY07 to 9% by FY10. There are three key reasons for this significant margin expansion: (1) nearly half of the new company owned stores that are coming up during this period would be purchased outright (and not leased), whereby margins are higher compared to leased stores; (2) with same-store sales growth trends improving, we expect operating leverage to start kicking in and supporting margin expansion for existing stores; and (3) better absorption of various fixed overheads (supply chain, administrative, etc) with rising scale.

Samuels, which so far has been sourcing jewelry from third party vendors for retailing via its stores, has now started to source this from Gitanjali's manufacturing facilities in India. We estimate that this backward integration would result in huge savings and would improve margins significantly from nearly 1% in FY07 to 7% by FY10. A similar approach will be followed in regard to the recently acquired Rogers retail chain in the US. A further consolidation of distribution and administrative operations of various retail chains (current and potential acquisitions) in the US would cut costs.

Figure 39: Revenue and margin trends for Samuels

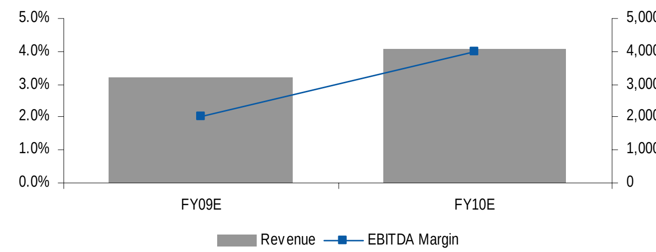
Rs in millions, %



Source: JPMorgan estimates.

Figure 40: Revenue and margin trends for other international acquisitions

Rs in millions, %



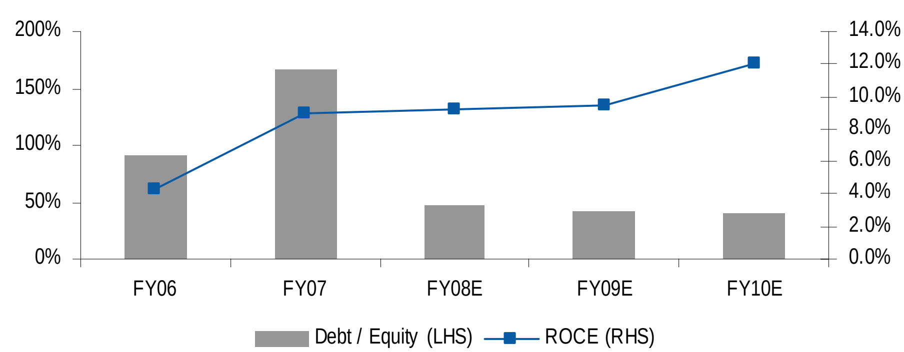
Source: JPMorgan estimates.

Significantly improved balance sheet profile

An inflow of US$180 million from the recently concluded GDR transaction has strengthened Gitanjali's balance sheet significantly. After considering the conversion of convertible bonds, the net worth of the company stands more than doubled, to US$500 million. Considering the current net worth, we expect Gitanjali can support growth in excess of 50% and still maintain a debt / equity ratio of less than 1. Funding constraints have also been cited, considering the SEZ initiative. We believe the company will actively seek a co-developer for these projects, and expect this business to largely remain self-funded beyond investments in acquisition of land.

Figure 41: Gitanjali Gems—Debt/Equity and ROCE trends

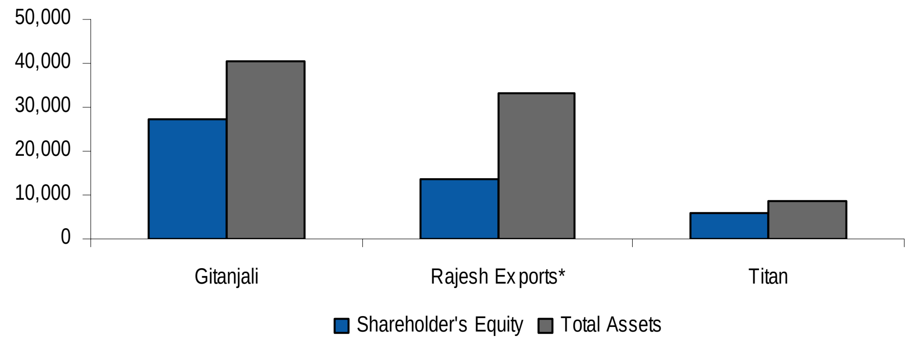
%



Source: Company reports and JPMorgan estimates.

Figure 42: Net worth and total assets of key jewelry companies

Rs in millions



Source: JPMorgan estimates. Note: * Bloomberg consensus estimates for Rajesh Exports.

Cash flow from operations likely to remain negative

As the diamond jewelry business is working-capital intensive and the company is planning significant expansion of both manufacturing and retail operations, we expect cash flow from operations to remain negative until FY10. We are estimating incremental working capital requirement of Rs8 billion over the next two years, and a large part of this would be deployed in retail inventory. Our estimates imply 100-120 days of receivables and inventory on aggregate basis. We do not envisage any major impairment in value of these assets as they are in line with industry norms.

Capex and funding plans

We estimate capex spends of Rs2 billion over the next two years as Gitanjali seeks to build its scale for the diamond processing and jewelry operations (both domestic and international). As the business is working capital intensive, we expect inventory requirements to remain high and forecast inventory increase of Rs8.7 billion over the next two years. However, unlike other businesses, we expect little impairment in inventory value as most of the jewelry could be recycled or sold at cost.

We estimate the company will also invest up to Rs1-2 billion in the SEZ operations at Hyderabad from its FCCB proceeds and internal accruals. Additional funding requirements for SEZ operations should be met from stake sale to a co-developer. Most of the SEZs in India work on a co-development model, and Gitanjali Gems also plans to adopt this model for development of SEZ infrastructure. Although it is difficult to ascertain the timing of materialization of such an alliance, we remain confident that this should happen over the next 6-12 months given the attractive proposition of the Hyderabad SEZ. The Hyderabad SEZ has been cited as a model SEZ under development by the Government of India in its Annual Economic Survey for 2007-08.

Recent quarterly performance

During 3QFY08, the company registered 57% Y/Y revenue growth based on 20% sales growth for the diamond business and 142% growth for the jewelry division. Net profit for 3QFY08 grew at 61% Y/Y. For 9MFY08, net earnings grew 62% Y/Y based on 51% revenue growth and 30bp expansion in EBITDA margins. Share of jewelry in the overall revenues rose from 28% in 9MFY07 to 43% in 9MFY08.

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Table 18: Consolidated quarterly performance for 3QFY08 and 9MFY08

Rs in millions

	Q3FY07	Q3FY08	Y/Y change	9MFY07	9MFY08	Y/Y change
Net sales	7,985	12,512	57%	22,097	33,433	51%
Raw material	7,264	10,881	50%	20,249	29,387	45%
Gross profit	721	1,631	126%	1,848	4,046	119%
Gross margin	9.0%	13.0%		8.4%	12.1%	
Staff cost	45	466	939%	119	983	727%
Other operating exp	181	381	111%	464	1,099	137%
Operating profit	495	784	58%	1,265	1,964	55%
Operating margin	6.2%	6.3%		5.7%	5.9%	
Other income	10	15	47%	16	80	406%
EBITDA	505	799	58%	1,280	2,044	60%
EBITDA margin	6.3%	6.4%		5.8%	6.1%	
Depreciation	9	48	417%	26	123	368%
EBIT	496	750	51%	1,254	1,921	53%
EBIT margin	6.2%	6.0%		5.7%	5.7%	
Interest	139	160	15%	321	425	32%
PBT	357	590	65%	933	1,496	60%
Tax	28	59	109%	105	168	60%
PAT	329	531	62%	827	1,328	60%
Minority interest	25	29	14%	55	67	22%
Associates	10	2	-75%	12	13	8%
Net profit	314	505	61%	784	1,274	62%
Net margin	3.9%	4.0%		3.5%	3.8%	

Source: Company reports.

Table 19: Consolidated quarterly (segment-wise)

Rs in millions

	Q3FY07	Q3FY08	Y/Y change	9MFY07	9MFY08	Y/Y change
Segment revenue						
Diamond	5,563	6,650	20%	16,181	19,257	19%
Jewelry	2,528	6,110	142%	6,176	14,702	138%
Total	8,091	12,760	58%	22,357	33,959	52%
Less: Inter-segment	106	248	133%	260	526	102%
Net sales	7,985	12,512	57%	22,097	33,433	51%
Segment results (PBIT)						
Diamond	206	163	-21%	518	674	30%
Jewelry	274	563	105%	692	1,173	69%
Others	1	-2	-457%	1	21	3057%
Total	481	724	51%	1,211	1,867	54%
Segment margin						
Diamond	3.7%	2.5%		3.2%	3.5%	
Jewelry	10.8%	9.2%		11.2%	8.0%	

Source: Company reports.

Financials

Table 20: Income statement

Rs in millions, year-end March

	FY07	FY08E	FY09E	FY10E
Revenue				
Diamond	23,833	27,388	28,977	30,660
Jewelry	9,856	16,220	22,973	33,198
International	1,300	4,124	4,433	4,660
New acquisitions		1,200	3,200	4,064
Inter-segment sales	315	700	1,000	1,200
Total	*34,674*	*48,232*	*58,583*	*71,382*
EBITDA				
Diamond	907	1,041	1,101	1,165
Jewelry	925	1,504	2,071	3,053
International	17	124	222	326
New acquisitions		24	64	163
Others	-69			
Total	*1,780*	*2,693*	*3,458*	*4,707*
EBITDA Margin				
Diamond	3.8%	3.8%	3.8%	3.8%
Jewelry	9.4%	9.3%	9.0%	9.2%
International	1.3%	3.0%	5.0%	7.0%
New acquisitions		2.0%	2.0%	4.0%
Total	*5.1%*	*5.6%*	*5.9%*	*6.6%*
Depreciation	70	154	246	324
EBIT	1,709	2,539	3,211	4,383
Interest	496	588	706	813
PBT	1,213	1,951	2,505	3,570
Tax	143	293	376	714
PAT	1,069	1,659	2,129	2,856
Minority Interest	98	104	94	99
Associates	6	10	13	17
Net profit	978	1,565	2,048	2,774
Exceptional items	-60	0	0	0
Reported net profit	918	1,565	2,048	2,774
EPS	16.6	16.0	19.1	25.8

Source: Company reports and JPMorgan estimates. Note: EPS is calculated on fully diluted shares.

Table 21: Balance sheet

Rs in millions, year-end March

	FY07	FY08E	FY09E	FY10E
Share capital	590	936	1,036	1,036
Reserves & capital	8,137	21,710	26,425	28,561
Shareholders' equity	8,727	22,645	27,460	29,596
	148	232	255	275
Minority interest	941	1,045	1,139	1,238
Secured loans	9,567	10,567	11,567	11,567
Unsecured loans	5,022	229	229	229
Total debt	14,589	10,796	11,796	11,796
Total liabilities	24,257	34,486	40,395	42,630
Goodwill	403	403	403	403
Gross Block	1,162	1,552	2,534	3,526
Less: Depreciation	232	385	632	956
Net block	931	1,167	1,903	2,570
Capital work in progress	275	275	275	275
Advances on capital A/c	147	147	147	147
Investments	229	1,829	3,329	4,329
Deferred tax assets	0	0	0	0
				8,749
Inventories	7,797	12,026	16,655	20,776
Sundry debtors	15,185	20,064	21,127	23,856
Cash & bank balances	6,175	6,118	6,577	2,898
Loans & advances	2,687	2,170	2,636	2,855
Total current assets	31,844	40,379	46,995	50,384
Current liabilities	9,313	9,250	12,038	14,668
Provisions	519	723	879	1,071
Total current liabilities	9,832	9,973	12,916	15,738
Net current assets	22,013	30,406	34,079	34,646
Expenditure during construction	14	14	14	14
Miscellaneous expenditure	245	245	245	245
Total assets	24,257	34,486	40,395	42,630

Source: Company reports and JPMorgan estimates.

Table 22: Cash flow statement

Rs in millions, year-end March

	FY07	FY08E	FY09E	FY10E
PBT	1,153	1,951	2,505	3,570
Depreciation	70	154	246	324
Interest (net)	496	588	706	813
Others	1	10	13	17
Change in WC:				
Trade & other receivables	-4,446	-4,362	-1,529	-2,947
Inventories	-5,168	-4,229	-4,628	-4,121
Trade & other payables	6,612	142	2,943	2,822
		-8,449	-3,215	-4,247
Taxes	-143	-293	-376	-714
Cash flow from operating activities	-1,426	-6,039	-120	-236
Purchase of FA	-1,094	-390	-982	-992
Acquisition of subsidiaries	-420			
Purchase of investments	-128	-1,600	-1,500	-1,000
Share of minority interest	322			
Cash flow from investing activities	-1,320	-1,990	-2,482	-1,992
Change in borrowings	5,171	-3,793	1,000	0
Share issue	243	12,624	3,120	0
Dividends	-110	-270	-353	-638
Interest paid (net)	-496	-588	-706	-813
Cash from financing activities	4,808	7,973	3,060	-1,451
Change in cash	2,062	-56	459	-3,680
Cash at beginning of year	4,113	6,175	6,118	6,577
Cash at end of year	6,175	6,118	6,577	2,898

Source: Company reports and JPMorgan estimates.

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Other Companies Recommended in This Report (all prices in this report as of market close on 10 April 2008)
Titan Industries Limited (TITN.BO/Rs1,065.60/Overweight)

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Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
This chart shows JPMorgan's continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
JPMorgan ratings: OW = Overweight, N = Neutral, UW = Underweight.

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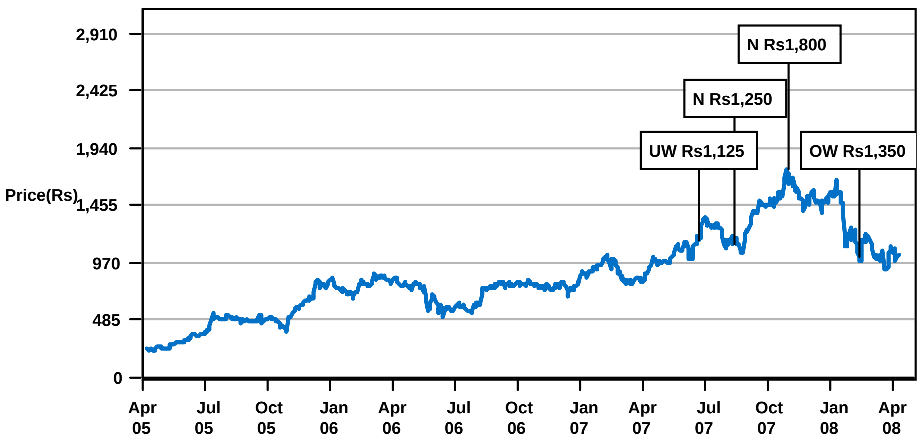
Titan Industries Limited (TITN.BO) Price Chart



Date	Rating	Share Price (Rs)	Price Target (Rs)
22-Jun-07	UW	1160.50	1125.00
13-Aug-07	N	1131.80	1250.00
30-Oct-07	N	1755.50	1800.00
10-Feb-08	OW	1024.25	1350.00

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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"Other Disclosures" last revised February 6, 2008.

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Gitanjali Gems: Summary of financials

Rs in millions, year-end March

Profit and Loss statement

	FY07	FY08E	FY09E	FY10E
Revenues	34,674	48,232	58,583	71,382
% change Y/Y	40%	39%	21%	22%
EBITDA	1,780	2,693	3,458	4,707
% change Y/Y	63%	51%	28%	36%
EBITDA margin (%)	5%	6%	6%	7%
EBIT	1,709	2,539	3,211	4,383
% change Y/Y	61%	49%	26%	36%
EBIT margin (%)	5%	5%	5%	6%
Net interest	496	588	706	813
Earnings before tax	1,213	1,951	2,505	3,570
% change Y/Y	85%	61%	28%	43%
Tax	143	293	376	714
as % of EBT	12%	15%	15%	20%
MI/Associate	92	94	81	82
Net income (adjusted)	978	1,565	2,048	2,774
% change Y/Y	82%	60%	31%	35%
EPS (Rs)	17	16	19	26
EPS growth	30%	-3%	19%	35%

Cash flow statement

	FY07	FY08E	FY09E	FY10E
EBIT	1,709	2,539	3,211	4,383
Depreciation & amortization	70	154	246	324
Change in working capital	-3,002	-8,449	-3,215	-4,247
Taxes	-143	-293	-376	-714
Others	-60	10	13	17
Cash flow from operations	-1,426	-6,039	-120	-236
Capex	-1,094	-390	-982	-992
Disposal/ (purchase)	-548	-1,600	-1,500	-1,000
Others	322	0	0	0
Cash flow from investment	-1,320	-1,990	-2,482	-1,992
Equity raised/ (repaid)	243	12,624	3,120	0
Debt raised/ (repaid)	5,171	-3,793	1,000	0
Interest & others	-496	-588	-706	-813
Dividends paid	-110	-270	-353	-638
Cash flow from financing	4,808	7,973	3,060	-1,451
Beginning cash	4,113	6,175	6,118	6,577
Ending cash	6,175	6,118	6,577	2,898

Balance sheet

	FY07	FY08E	FY09E	FY10E
Cash and cash equivalents	6,175	6,118	6,577	2,898
Accounts receivable	15,185	20,064	21,127	23,856
Inventories	7,797	12,026	16,655	20,776
Others	2,687	2,170	2,636	2,855
Current assets	31,844	40,379	46,995	50,384
Goodwill	403	403	403	403
Investments	229	1,829	3,329	4,329
Net fixed assets & capital WIP	1,206	1,442	2,178	2,845
Other	407	407	407	407
Total assets	34,089	44,460	53,312	58,368
Payables	9,313	9,250	12,038	14,668
Others	519	723	879	1,071
Total current liabilities	9,832	9,973	12,916	15,738
Total loans	14,589	10,796	11,796	11,796
Other liabilities	941	1,045	1,139	1,238
Total liabilities	25,362	21,814	25,852	28,772
Shareholders' equity	8,727	22,645	27,460	29,596

Ratio analysis

%	FY07	FY08E	FY09E	FY10E
EBITDA margin	5%	6%	6%	7%
EBIT margin	5%	5%	5%	6%
Net profit margin	3%	3%	3%	4%
Sales growth	40%	39%	21%	22%
Net profit growth	82%	60%	31%	35%
EPS growth	30%	-3%	19%	35%
Interest coverage (x)	3.4	3.3	3.3	4.4
Net debt to total capital	44%	17%	15%	24%
Net debt to equity	96%	30%	21%	31%
Sales/assets	1.4	1.4	1.5	1.7
Assets/equity	2.8	1.5	1.5	1.4
ROE	12%	10%	8%	10%
ROCE	9%	9%	10%	12%

Source: Company reports and JPMorgan estimates. Note: EPS is calculated based on fully diluted shares.